Market Power in Emission Permit Markets: Theory and Evidence from the EU ETS

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A well-known result about market power in emission permit markets is that efficiency can be achieved by full free allocation to the dominant firm. I show that this result breaks down when taking the interaction between input and output markets into account, even if the dominant firm perceives market power in the permit market alone. I then examine the empirical evidence for price manipulation by the ten largest electricity firms during phase I of the EU ETS. I find that some firms' excess allowance holdings are consistent with strategic price manipulation, and that they cannot be explained by price speculation or by precautionary purchases to insure against uncertain future emissions. My results suggest that market power is likely to be an empirically relevant concern during the early years of emission permit markets.
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